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Proxy solicitation under fire as votes near

By Marcia Parker

As corporations attempt to influence the voting of their pension funds' proxies, the proxy solicitation process is coming under increasing attack, with some calling the system unfair and at least one independent expert saying it is subject to "outright fraud."

The upcoming spring proxy season will place the system under growing pressure, as record numbers of proxy sponsors are placing myriad resolutions before corporations on issues ranging from poison-pill withdrawals to South Africa divestiture.

"The biggest issue facing corporate America today is who has the ultimate right to vote these shares, who has the right to influence those votes, and how much influence is allowable," said Don Carter, president of The Carter Organization, a leading proxy solicitation firm in New York.

"In the past, there was a lack of knowledge and indifference about voting procedures and policies. Now that executives understand how important the vote is, they are asking questions."

Shareholders increasingly are challenging a system they claim is misunderstood, ill-defined and sometimes stacked against them. Many are calling for key changes, including secret ballots, indepen-

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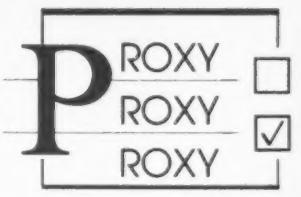

Pensions & Investment Age

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High hedging costs surprise funds

By Trudy Ring

Portfolio insurance cost some pension funds 50 to 100 basis points more than expected in 1986, largely because of the stock market's volatility, especially during the second half of the year.

Experts in the field said cost projections usually are 200 to 300 basis points a year; the actual cost in 1986 likely was 50 to 100 basis points higher.

Portfolio insurance, also called dynamic hedging, generally involves the short sale of stock index futures to create a synthetic put option on a large portfolio. The goal is to hold portfolio losses to a pre-specified level in a down market; the cost is underperformance in an up market.

"The costs were well in line with expectations during the first half (of 1986), but higher than expected in the second half, due to the choppy, trendless market," said C.F. Lemons, director-trusteed benefit funds at Manville Corp., Denver.

This led Manville to modify its dynamic hedging program, which it uses on its entire $756 million pension fund, Mr. Lemons said. The program had aimed for a 0 minimum rate of return over a three-year time horizon; Manville changed this to a −5% return.

Several pension funds use a negative minimum return in portfolio insurance programs. This doesn't mean they are likely to end up with a negative return, but lowering the minimum return means they lower the cost of hedging because they won't have to put hedges on the fund as frequently.

"There's a trade-off in terms of cost," Mr. Lemons acknowledged.

Nevertheless, he said, dynamic hedging has been worthwhile for the Manville fund, which was one of the technique's earliest users, in 1984. The program has allowed the fund to lock in substantial gains and cut contributions, he said.

The $350 million Minneapolis Teachers' Retirement Fund, one of the few public funds using dynamic hedging, also saw costs exceed expectations in 1986. "It did cost us a little more than projected, because of the increased volatility," said Harry Adams, executive secretary and investment manager. "It was not a dramatic increase."

The fund, which started using dynamic hedging last spring, will make a routine review of the program at the end of its first year. "I would think that we would continue some form of portfolio insurance during the coming year," Mr. Adams said. "I would hope my trustees would see the advantages of some sort of program."

The fund applies the hedge to $185 million in equities, which was its entire equity allocation at the time the program started. The equity allocation now is up to $250 million, the result of market gain and increased allocation made possible by the hedge, Mr. Adams said.

Even though the price tag on dynamic hedging for the $200 million equity portfolio of the $300 million San Diego Gas & Electric Co. pension fund also was higher than expected, it's too early to judge the

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Inside:

ESOPs: The retirement of Sen. Russell Long of Louisiana has left employee stock ownership plan advocates seeking a new champion. *P&I Age* examines this and other issues facing ESOPs in a special report — page 15.

CASH MANAGEMENT: Differences in state laws are causing HMOs, such as Humana, some of whose employees are shown below, to decentralize cash operations. This boosts fees, lowers returns — page 31.

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Japanese lifting U.S. investment

By Joel Chernoff

Japanese investors, long major buyers of U.S. Treasury securities, are expected to pour between $15 billion and $20 billion into the U.S. stock market this year, but a few observers think the total could be $200 billion to $300 billion within three years.

Even a $15 billion to $20 billion influx would far exceed last year's $6 billion in net new purchases by Japanese institutional and retail investors, and is a far cry from the $1 billion invested in 1985.

The infusion from the Japanese institutions is expected to help prolong the current bull market.

"In terms of equities, I predict an avalanche. If you want to stay on top of things, you better get a pair of skis," said Robert Brusca, senior vice president and chief economist for Nikko Securities Co. International, New York.

Mr. Brusca predicted new money invested in U.S. stocks by the Japanese in 1987 would total $52 billion to $60 billion, buoyed by Japan's huge trade surplus, loosened restrictions permitting Japanese institutions to invest more abroad, a more stable exchange rate with the dollar and relatively cheap values for U.S. stocks.

He said the total easily could top $200 billion during the next three years and might well reach $300 billion — or roughly 10% of the current capitalization of the U.S. stock market.

Similarly, William Jacques, who recently left Batterymarch Financial Management, Boston, to become a partner in newly formed Martingale Asset Management, Boston, estimated Japanese investors will put $150 billion to $200 billion in U.S. stocks during the next two years.

Major Tokyo managers are among Japanese investors expected to put $15 billion in U.S. stocks.

Cheaper U.S. stocks are attractive to the Japanese, of course. In addition, Mr. Jacques said, the Japanese government has quietly signaled to investors there to buy U.S. stocks in an amount equal to the $200 billion they now hold in U.S. fixed-income securities.

The Japanese have four times the savings rate of Americans, with an economy half as big, he said.

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ESOP may be key in Harper & Row takeover

By Brad Rudin

Harper & Row Publishers Inc.'s continued existence as an independent book publisher could rest in the hands of its employees, who hold 29% of the company's stock in an employee stock ownership plan.

"While they don't control the company, they do have a large block of stock," said J. Kendrick Noble, an analyst at PaineWebber Inc., New York. "Therefore they could be a swing factor in the vote."

Harcourt Brace Jovanovich Inc., an Orlando, Fla.-based book publisher, earlier this month proposed to pay Harper & Row stockholders $50 cash a share for the New York company. Another offer, $34 a share, came from private investor Theodore Cross. Harper & Row stock had been trading at $25 at the time of Mr. Cross' offer in early March. The stock closed at $52 March 17.

Harper & Row's board of directors retained Kidder, Peabody & Co., New York, as its financial adviser and appointed a committee of independent directors to study options.

The chairman of the committee, Winthrop Knolton, said in a prepared statement the company will consider all options, "including continuation of our existing business plans, possible business combinations, sales of stock, restructuring and the sale of all or part of the company."

Harper & Row postponed indefinitely an April 2 vote on the creation of two classes of stock shares with different voting rights.

If Harper & Row employees vote for a takeover, they stand to gain as stockholders. But acquisition of the company could jeopardize their job security.

Harper & Row's unionized workers have not made their views known to District 65 of the United Auto Workers, New York, which represents 50% of the company's non-managerial employees, said Patricia Slesarchik, a union official.

The plan document governing the 6-year-old ESOP gives employees the right to vote and tender their own shares, said Edward A. Miller, Harper & Row's general counsel.

Manufacturers Hanover Trust Co., New York, serves as the ESOP's trustee.

What role Manufacturers Hanover would take in a vote or tender offer remains unclear.

"The bank still has the responsibility, and the bank will have to decide whether what the participants want to do is proper," said a lawyer who asked not to be named.

The Employee Retirement Income Security Act of 1974 gives the trustee the responsibility to manage and dispose of ESOP plan assets unless an investment manager is appointed to control the assets or unless a named fiduciary assumes the responsibility, the lawyer said.

"There's a big debate whether you can give something like an investment decision to plan participants," said Thomas A. Jorgensen, a lawyer with Calfee, Halter & Griswold, Cleveland.

David M. Binns, executive director of the Employee Stock Ownership Association, a Washington-based trade group, said he opposes any formula that would give trustees final say over ESOP plan assets.

A rule giving final authority to the trustee would deprive both employees and managers of their ability to shape the company's future, he said, adding this result would be most anomalous when the ESOP owned most of the company's shares. ■

University fund tops bull market

By Steve Hemmerick

BERKELEY, Calif. — The $9 billion University of California pension fund is using active in-house equity management to beat the same roaring bull market that has left many others behind.

While the thinly staffed UC investment team bettered the Standard & Poor's 500 stock index in 1986 by just less than four percentage points, some equity money managers are complaining it's tough to beat a bull market and will make it up when the market turns bearish.

Those managers have a lot of catching up to do. According to the Trust Universe Comparison Service, a performance evaluation service with 43 member banks and insurance companies, about 64% of the active equity managers couldn't beat the S&P 500 in 1986, although they were paid millions of dollars in fees to do so.

The UC pension fund's equity portfolio returned 22.4% in calendar 1986, while the S&P returned 18.7%. The median TUCS portfolio returned 16.8%.

For the two years ended Dec. 31, the UC equity portfolio returned a compound annual 27.1% vs. 25.1% for the S&P; the TUCS median was 22.4%. And for three years, UC returned an annualized 19.1% vs. 18.5% for the S&P and 16% for the TUCS median.

For the first two months of 1987, the retirement system had an equity return of 18% vs. 16.5% for the S&P 500.

Because of its performance, the retirement system logged a gain of $1.2 billion in assets, to $9.2 billion at the end of February from $8 billion at the end of 1986.

And the endowment fund, which has slightly better return figures than the retirement fund in the past three years, jumped to $980 million at the end of February from $860 million at the end of 1986.

The money is managed actively because "we don't believe in" passive management, said Patricia A. Small, associate treasurer for the university.

She said there are too many "me-too" second-rate companies in the S&P. The retirement system wants to invest in companies that are "dynamic growers in the economy," she said.

When salaries for the 11 professionals on the team that runs both the pension and the endowment fund are subtracted, UC's performance still shines, she said.

Ms. Small said she couldn't estimate how much money the system saves by using university-employed workers instead of external active money managers: Fees for external managers vary too markedly. She did say the entire investment office budget for about 30 people, including secretaries, is about $2 million a year.

On a balanced-fund basis, the retirement system is at or near the top of the 10,000-portfolio universe of SEI Funds Evaluation, Wayne, Pa.

For the year ended Dec. 31, the retirement system returned 23.2% for total fund performance, while the top quartile breakpoint in the SEI balanced universe was 18.1% and the median was 15.6%.

For two years, the retirement fund returned a compound an-

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Clothing Workers union members protest a financing agreement that affects their Reeves pension plan.

Termination draws union ire

By Trudy Ring

The Amalgamated Clothing and Textile Workers Union is fighting the proposed termination of Reeves Brothers Inc.'s pension plans, whose excess assets will be used to pay down debt incurred by Schick Inc. in its acquisition of Reeves last year.

The union is launching a campaign against the nine banks that financed Darien, Conn.-based Schick's acquisition of Reeves, Spartanburg, S.C. The situation also is likely to put overfunded plan terminations under more scrutiny by Congress; a Reeves worker is scheduled to testify at a joint meeting of House and Senate subcommittees March 24.

The loan agreement between the nine banks and Schick states that upon receipt of any surplus from termination of Reeves' salaried or hourly pension plans, Schick will use up to $20 million of that surplus as a loan payment. The document also says Schick and Reeves agreed to seek termination of the plans as soon as possible.

Schick has filed with the Pension Benefit Guaranty Corp. for termination of the salaried plan, but not for the hourly plan. Union officials said they believe the loan agreement mandates termination of both plans.

The union and the Virginia AFL-CIO began the campaign with a demonstration March 10 at Sovran Bank, Richmond, Va. Demonstrations and meetings with officials at other banks are planned, said Bill Patterson, national field director for the union.

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The *P&I Age* monthly indexes track the changes in the Standard & Poor's 500 stock index, the Frank Russell Co.'s Russell 3000 stock index, the Ryan Index of fixed-income securities and the Shearson Lehman Government/Corporate bond index.

P&I Age February Indexes

	Latest mo.	Year to-date	Trailing 12 mos.
S&P 500	3.95	17.96	29.54
Russell 3000	4.71	18.14	26.64
Ryan Index	.48	1.38	12.28
Shearson Lehman Gov't./Corp.	.66	2.04	12.54

Source: Rogers, Casey and Barksdale Inc.

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Groups to fight SEC ruling on ads

By Chuck Paustian

Members of the investment management community intend to fight the Securities and Exchange Commission staff's decision to require performance figures in advertisements to reflect management fees and other costs paid by clients.

Both the Investment Counsel Association of America, New York, and the Investment Company Institute, Washington, plan to seek further guidance on, and possible alteration of, the SEC staff's position.

The staff's views were promulgated in a no-action letter sent to Clover Capital Management Inc., Pittsford, N.Y., at the end of 1986.

In an important policy switch, the division of investment management staff said it no longer would take the position that the use of a model portfolio or actual results in an advertisement is necessarily fraudulent.

In approving Clover's use of model portfolio returns, the staff took the opportunity to give broader guidance on performance measurement because "of the significant degree of interest in this issue." The SEC had promised to give such guidance since early 1986.

The letter said performance figures used in advertisements, including such items as marketing brochures and possibly data sent to consultants, would be prohibited if, among other things, they include "model or actual results that do not reflect the deduction of advisory fees, brokerage or other commissions, and any other expenses that a client would have paid or actually paid."

An SEC official, who asked not to be identified, said the staff may recommend formal changes to the advertising rule after a comprehensive review.

While agreeing with most of the letter's content, executives of investment management organizations took exception to the provision regarding management fees and other costs.

These executives contend performance data net of fees and other costs would not be meaningful because the fees vary not only among firms, but also frequently within a particular firm.

In addition, they said the other costs paid by the client, such as custodian fees, are not known by the adviser and are subject to negotiation.

"We think the key to proper presentation of performance is full disclosure of how the numbers are computed," said Keith J. Rudolf, legal counsel for Stein Roe & Farnham, Chicago, and chairman of the legal and regulatory committee of the ICAA.

"We are also seeking additional interpretive information because (the staff's decision) is contrary to the types of investment advisory performance numbers that have been shown historically," said Robert L. Bunnen Jr., assistant general counsel for the Investment Company Institute.

Mr. Rudolf said one possible solution would be to allow managers to continue presenting performance figures before fees as long as that fact is clearly disclosed.

Both Messrs. Rudolf and Bunnen declined further comment until their organizations' formal requests are filed with the SEC.

The SEC official said any proposals submitted to the SEC staff would be reviewed.

The official added, however, one of the staff's concerns is that exclusion of advisory fees from performance figures during an extended period of time would have a compounding effect during the later years. A footnote may not adequately cover that matter, he said.

If enforced, the SEC staff's position would alter dramatically the way managers present performance numbers; most don't include management fees and other costs in their performance data.

Ronald D. Peyton, president of Callan Associates Inc., San Francisco, noted 70% of the managers in his firm's universe present performance data before fees.

"It's a real hodgepodge and you always have to ask," he said.

Roger C. Bransford, partner in the Atlanta office of D.L. Eager Associates, Louisville, Ky., said for years he and other individuals have been calling for a self-policing effort by managers and consultants.

It was the pension community's inability to agree on a standard method of performance measurement that resulted in the SEC staff's position, he said.

"My attitude toward it is frankly, this is a chipping away of the freedom and flexibility that the investment managers have," he said, adding those days of flexibility are numbered.

"This in and of itself is significant but I think the greater significance may rest in the fact it may be a precursor for even tougher regulation that's coming down."

Despite its onerous implications, "In some ways it's also better to have a known out on the table so you can go ahead and deal with it," he said.

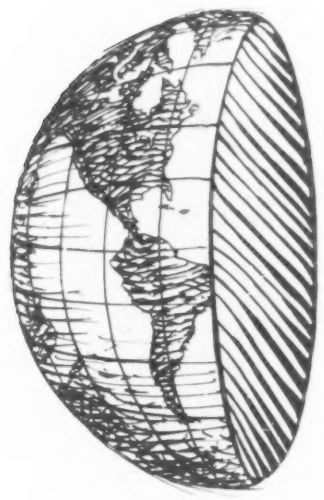
Other pension industry executives said while they appreciate what the SEC staff is trying to accomplish, they believe the issue is being addressed improperly.

Said a top executive at a large investment management firm, who asked not to be identified: "To us, nobody is confused because the plan sponsor who gets the results knows it's before fees and they know what the fees are."

He said his firm would comply with any SEC decision.

"This is the age-old problem in comparing performance results: What is it net of?" said James Knupp, principal of Ennis, Knupp & Associates Inc., a consulting firm in Chicago.

Mr. Knupp said he agreed management fees and other costs are an issue, but "it's trivial compared to the true quality of the basic underlying data." ■



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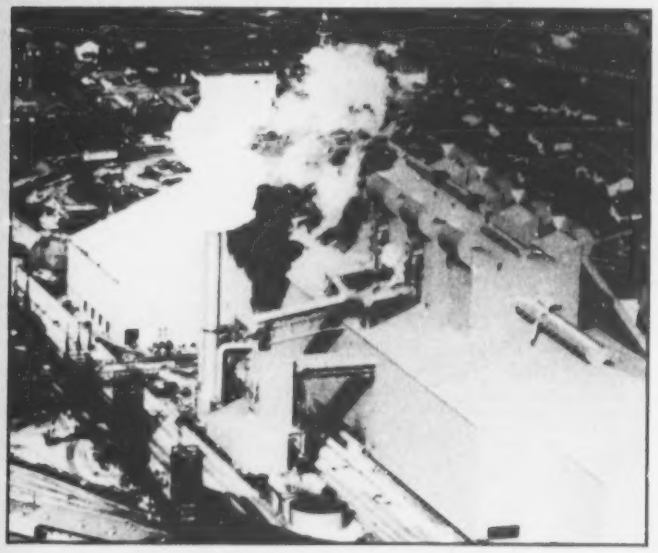
Corrections & clarifications

• In her testimony before the Senate Finance Committee, Kathleen Utgoff, executive director of the **Pension Benefit Guaranty Corp.**, said the agency's proposed risk-related premium would not increase premiums for two-thirds of plans and almost 60% of participants in single-employer plans. Her testimony was reported incorrectly in the March 9 issue.

• **Aetna Life & Casualty** was inadvertently omitted from the March 9 list of top gainers in portfolio insurance business for 1986. Aetna would have placed first, with $12.3 billion.

• A March 9 Pensions & Investments' Performance Evaluation Report international article misidentified the parent company of **Provident Capital Management Inc.**, Philadelphia. It is Provident National Bank, Philadelphia.

ESOPs



Weirton Steel Co., which operates this plant in Weirton, W. Va., established an employee stock ownership plan in 1983 that experts now regard as a true success story.

Dan River, Weirton: A tale of two ESOPs

By Fred Williams

Dan River Inc. and Weirton Steel Co., both troubled companies in 1983, turned to employee stock ownership plans to put themselves back on even keels.

But while both companies survived and hundreds of jobs were preserved, only Weirton is regarded by industry observers as a true ESOP success story.

Employee benefit experts are troubled by several aspects of the Danville, Va.-based Dan River plan, among them the motivation of management in establishing it.

Controversy surrounded the formation in 1983 of leveraged ESOPs to buy the two companies from their previous owners so the companies could continue operating as they had before the buy-outs. The inception and evolution of these two ESOPs represent the poles between which other ESOPs fall.

The Weirton Steel, Weirton, W. Va., plan embodies all that traditional ESOP supporters believe is possible through employee ownership; the establishment of the Dan River plan is viewed by these same traditionalists as a financial maneuver — favoring entrenched management — to fight a hostile takeover attempt.

Weirton employees voted to purchase the steel unit from National Steel Corp. in fall 1983 for $194.2 million. Terms of the agreement, which was proposed by the employees, called for employees to take a 20% pay cut and became one of the important test cases for employee ownership on a large scale.

Dan River's ESOP was formed to acquire 70% of the company's stock as the culmination of a nine-month battle to ward off a hostile takeover attempt by Carl Icahn, who had acquired 30% of Dan River stock. The ESOP was proposed, and is controlled, by management.

The company terminated its defined benefit pension plan and used the $16 million surplus to make the first payment on a $150 million bank loan to purchase stock.

A look at the ESOPs now shows both have worked in the way they were intended, but are viewed much differently by employee benefit specialists.

Both companies operate in troubled industries. Both were only marginally profitable in 1983

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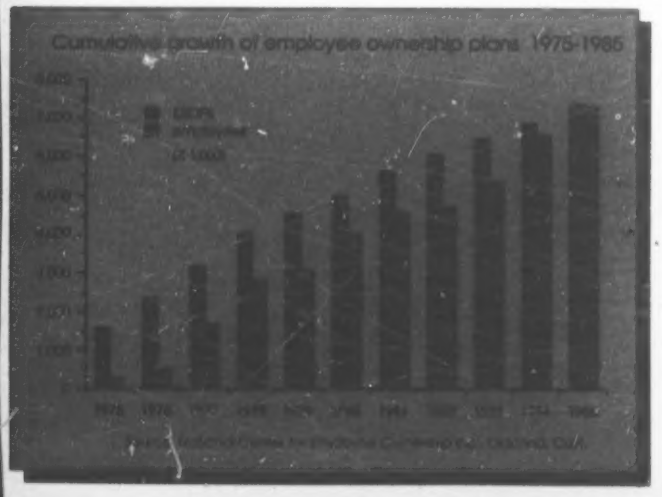

Searching for a hero

Long's successor facing tougher struggle

By Richard Gillespie

WASHINGTON — Advocates of employee stock ownership plans are seeking a new champion to carry on what likely will be a much tougher struggle to preserve ESOP legislation.

The retirement of Sen. Russell Long, D-La., the prime architect of ESOP laws, coincides with closer examination of the use of ESOPs by tax attorneys and Wall Street to snag advantages for corporations.

"ESOPs have been manipulated in so many ways that are harmful to their beneficiaries that if they do have a future, that is a mixed blessing," said Mike Gordon, a Washington pension attorney.

Said Marc Zimmerman, vice president at the ESOP Consulting Group, Washington: "Now that Russell Long is gone, people may start taking potshots at ESOPs, especially given the favorable tax situation they are in."

The Tax Reform Act, which includes ESOP provisions engineered by Sen. Long, was generally favorable to ESOPs. Repeal of the tax credit for contributions to payroll-based ESOPs was the only adverse change.

But in response to alleged manipulation of ESOPs, legislation and regulatory activity has been proposed. Among the proposals:

- The Reagan administration, through its competitiveness package, wants to eliminate ESOP-based floor-offset plans (in which benefits promised in a defined benefit plan are offset by a defined contribution plan) by reducing to 10% the amount of employer securities that can be held in such plans.
- In the Senate, Sen. Lloyd Bentsen, D-Texas, chairman of the Senate Finance Committee, has introduced a bill proposing curtailment of the provision that allows an estate to exclude from taxation 50% of the sale of the stock of an ESOP.

The retirement of Sen. Russell Long, D-La., could mean tough times ahead for ESOPs.

Rep. Dan Rostenkowski, D-Ill., chairman of the House Ways and Means Committee, and Rep. John J. Duncan, R-Tenn., ranking minority member on the committee, have launched an identical bill in the House.

- The Labor Department's ERISA Advisory Council, a panel of experts which advises the secretary of labor on employee benefits policy, recently set up a special ESOP working group, which will investigate the use of ESOPs in leveraged buy-outs.

The working group will hold public hearings the first week in April.

- ESOPs also will be affected by a new regulation the Labor Department plans to issue by summer regarding Section 318 — the adequate consideration rule — of the Employee Retirement Income Security Act.

ESOPs are exempt from the 10% restriction on investment in employer securities under the adequate consideration test contained in Section 318.

In addition, Roger Thomas, counsel to the House Select Committee on Aging, said there is concern among the staff on various committees regarding all ESOP-related provisions of the 1986 Tax Reform Act, and in particular over the 50% exclusion of estate sales to ESOPs and the exclusion from the 10% excise tax for surplus rollovers into ESOPs.

The Labor Department has other regulatory projects on its drawing board that also might affect ESOPs, said David Walker,

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Plans are financing tools

By Brad Rudin

Tax benefits, liquidity and the promise of improved productivity have combined to give employee stock ownership plans a secure foothold as a corporate finance technique.

Although recognized by the Employee Retirement Income Security Act as a tax-qualified retirement plan, ESOPs are typically not viewed as such.

"We feel very strongly that ESOPs are not pension plans," said Corey Rosen, executive director of the National Center for Employee Ownership, Oakland, Calif.

"ESOPs should not be confused with retirement plans," added Frank M. McArdle, education and communications director of the Employee Benefit Research Institute, Washington. "Having all your eggs in one basket is risky," he said.

Replacement of a defined benefit plan with an ESOP to aid a financially distressed company — as was the case with Raymond International, Houston — points up the risk because this kind of transaction leaves employees with shares in a troubled company.

Raymond terminated its defined benefit plan in 1983, using the $30 million reversion to help finance a $219 million leveraged buy-out of the company by the ESOP.

But an ESOP can also be used successfully to reduce corporate debt, improve employee morale and insulate a company from a hostile takeover.

This was the case with Ashland Oil Inc, Ashland, Ky. Ashland Oil earlier this month recaptured about $200 million in surplus pension assets.

"We believe this was the most efficient use of an ESOP," said William R. Seaton, Ashland's vice chairman.

The transaction gives the company $200 million that is exempt from income tax and the special excise tax on defined benefit plan reversions. Recognition of this

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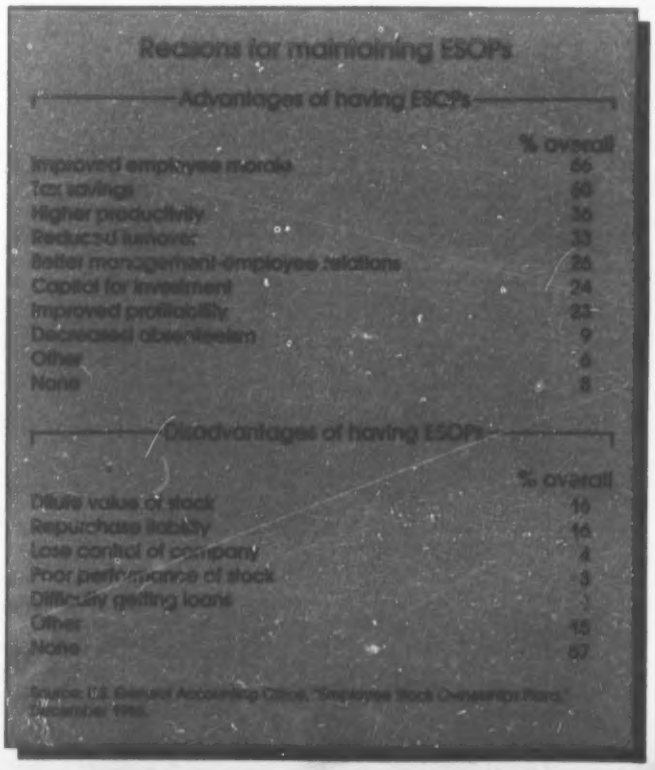

Plans are tool . . .

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gain will reduce the company's debt-to-equity ratio to 35% from 27%, Mr. Seaton said.

Ashland also regards the "very distinct and thorough feeling of company ownership" among employees as a major advantage, Mr. Seaton said.

Another plus, he said, is having 20% of the company's shares held by employees who might be more resistant to corporate raiders.

In April 1986, the energy company purchased 5.35 million newly issued shares of Ashland common stock to establish a $255 million ESOP that would form a floor-offset arrangement with the existing defined benefit plan.

Under floor-offset plans, if the value of a participant's account in a defined contribution plan fails to provide the minimum promised benefit, the defined benefit plan provides the balance.

Despite success stories like Ashland's, some concerns surround ESOP use, including stock repurchase liability, administrative costs, dilution of the value of existing stock and the prospect of employee interference with management.

Stock repurchase liability will emerge as the biggest ESOP issue of the 1990s, said Paul J. Much, a principal at the Los Angeles office of Houlihan, Lokey, Howard & Zukin, a valuation advisory firm. This liability arises because retirees have the right to put their shares back to the employer at current fair market value.

Independent appraisers are retained to set the price of shares issued by privately held companies, while the stock market price determines the liability of publicly owned companies.

Employers with ESOPs "have this time bomb (stock repurchase liability) ticking away that if they haven't planned for could force them into selling the company or force them into having to take the company public," Mr. Much said.

In addition, even the most ardent supporters of ESOPs acknowledge employee ownership is only a small part of the work force.

About 8,000 employers cover 8 million employees, approximately 7% of the work force, with benefits provided by ESOPs.

Interest in ESOPs has increased, in part, because of the benefits created by the Tax Reform Act of 1986, said Donald C. Weeden, a managing director at Morgan Stanley & Co., New York. "There are a lot more companies today looking at the use of ESOPs than there were two years ago."

ESOPs emerged from the Tax Reform Act of 1986 with most of the old tax advantages for corporations intact and some new ones added to the list.

Among the tax provisions having the most impact was the widening of the 3-year-old 50% exclusion on interest earned from loans to ESOPs by allowing the exclusion to apply to loans made to the employer if stock equal in value to the loan is transferred to the plan within 30 days.

The provision allowing lenders to exclude from their income 50% of the interest earned on ESOP loans has made employee ownership a more familiar concept to loan officers. "So now it's less likely that when a company goes to a bank and says, 'I want to do some ESOP financing,' that it gets met with a blank stare," said David Binns, executive director of The Employee Stock Ownership Association, a Washington research and lobbying group.

By granting the exclusion, Congress enabled lenders to provide below-market rate loans to ESOPs and the sponsoring employer.

"We're seeing a lot of activity, especially in the ability to use excess pension assets in an ESOP," said William E. Mattingly, a partner in the Chicago law firm of Katten, Muchin, Zavis, Pearl, Greenberger & Galler.

Tax-free transfers of surplus pension plan assets to an ESOP can improve cash flow if that money is used to reduce payments to a defined contribution plan, he said.

Interest in employee stock ownership also is sustained by the tax code's favorable treatment of leveraged ESOPs.

In a leveraged ESOP, borrowed funds are used to buy employer stock for the trust. In a nonleveraged ESOP, the employer uses its own funds to purchase the stock.

Shares acquired by a leveraged ESOP are held in a suspense account, which may be used as collateral for the loan. Shares are allocated to plan participants as the loan is paid off.

Corey Rosen's organization feels ESOPs cannot be regarded as pension plans.

David Binns of the Employee Stock Ownership Association says banks know about ESOPs.

The employer's cost of borrowing is reduced in a leveraged ESOP, which accounts for about a third of employee ownership plans, because the funds used to repay the debt are deductible from pre-tax corporate income.

The 15% contribution limit for profit-sharing and stock bonus plans doesn't apply to leveraged ESOPs, which are allowed to make tax-deductible contributions of up to 25% of the covered payroll to make principal repayments. All contributions for interest payment are tax deductible.

In nonleveraged ESOPs, employers benefit because their stock contributions are tax deductible up to 25% of the covered payroll although no cash payments are made. As a result, after-tax cash flow can increase.

ESOPs also are considered a valuable corporate finance tool because of their role in leveraged buy-outs.

But Department of Labor concerns about the equity proposed to be allocated to the ESOP of Scott & Fetzer Co., Westlake, Ohio, have put a cloud over ESOPs in leveraged buy-outs.

Under the terms of the proposed Scott & Fetzer buy-out, the ESOP would have received a 41% equity stake in the company even though its $182 million tax-sheltered loan represented more than the cash invested by other investors.

Although the Labor Depart-

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ESOPs with 66% or more employee ownership*

Company	Number of employees	% owned
Publix Supermarkets	31,000	100
Weirton Steel	8,200	100
Parsons Corp.	7,000	100
Lifetouch	4,000	100
Davey Tree Expert	3,200	100
American Cast Iron Pipe	3,100	100
OTASCO	2,600	100
Federal Hoffman	2,500	100
CH2M Hill Inc.	2,300	100
Okonite Co.	1,800	100
Bureau of National Affairs	1,500	100
Katz Communications	1,500	100
North American Rayon	1,300	100
Denver Yellow Cab	1,200	100
TDI Industries	1,200	100
Amsted	6,900	98
W.L. Gore & Associates	3,000	95
Halmode Apparel	1,200	89
Science Applications	6,000	85
Thomson-McKinnon	4,130	76
Avondale Industries	10,000	70
Dan River Co.	6,500	70
Alco-Gravure	1,200	70
STV Engineers	1,200	65-70

* As of June 1986
Source: National Center for Employee Ownership, Oakland, Calif.

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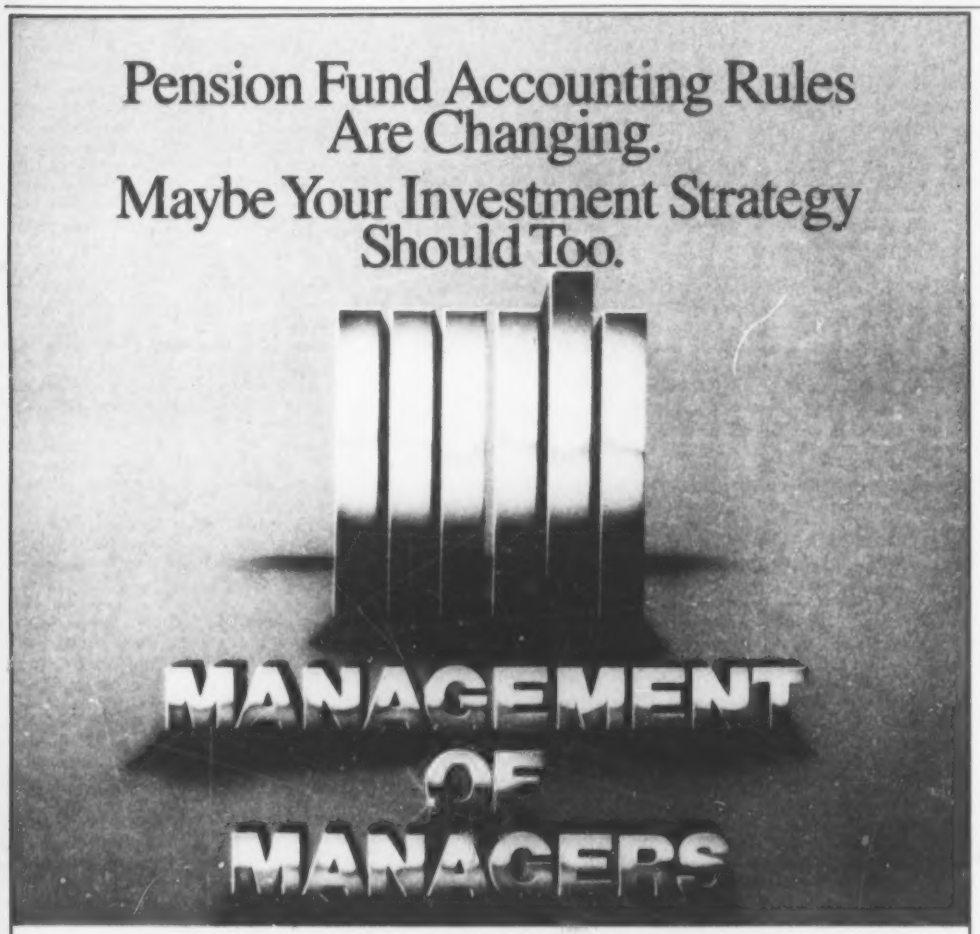

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deputy assistant secretary of the Department of Labor, such as pass-through voting rights, corporate governance and takeover matters.

Mr. Thomas said pass-through voting "gets back to who owns the corporation, to what extent participants own the corporation through their holdings in ESOP arrangements."

"With a leveraged buy-out, the bank advancing the funds may hold a substantial interest in voting those shares until the loan amounts are paid off, so employees only get a graduated ownership based on the repayment of those amounts."

Regarding takeovers, he said, "ESOPs have been used offensively and defensively." For example, at Bluebell Inc., Greensboro, N.C., various classes of stock were issued to management and participants, with fewer voting rights issued to participants.

"Under the terms," said Mr. Thomas, "Bluebell's management would have profited handsomely from appreciation of the stock or its sale, or more so than the rank-and-file.

At Harper & Row Publishers Inc., New York, he said, "the company purchased the shares from a principal stockholder and placed them in an ESOP, effectively for the purpose of taking them out of the open market so they would not be available to a potential takeover candidate."

Rep. William Clay, D-Mo., chairman of the Labor-Management Relations Subcommittee of the House Education and Labor Committee, recently expressed concern that ESOPs are "sometimes put together in ways that are harmful to their members' interests," a subcommittee spokesman said.

"Frequently, it is the employees who come out on the short end. In some instances, they lose whatever pension security they might have had," he said.

Although no clear lines have been drawn in the Senate, Sen. Bill Bradley, D-N.J., has called for a repeal of the estate tax provision in the Tax Reform Act.

In the House, Fortney H. "Pete" Stark, D-Calif., has been identified as an opponent of ESOPs.

The Employee Stock Ownership Association, Washington, a 1,000-member lobby group, referred in a recent newsletter to such opponents as an "ill wind blowing through the nation's capital."

On the other side are those willing to fill the shoes of Sen. Long. While there are many eligible candidates, none would compare himself to Sen. Long in either stature or commitment.

"You cannot minimize the loss of someone like Sen. Long. His influence was rare even among powerful senators," said David Binns, executive director of the Employee Stock Ownership Association.

"Having lost a champion of that magnitude it would be difficult to say we were in as good a position as in the past," he said.

Among the emerging leaders are:

- Sen. Spark M. Matsunaga, D-Hawaii, a member of the Senate Finance Committee who considers Sen. Long to be his mentor both philosophically and politically and who considers the ESOP legislation to be among Sen. Long's greatest achievements.
- Sen. Max Baucus, D-Mont., who sponsored the provision in the 1986 Tax Reform Act that enables companies to avoid payment on the 10% excise tax on asset reversions by rolling the surplus into an ESOP.

Sen. Long sponsored the other provisions.

- Sen. John D. Rockefeller IV, D-W. Va., who as governor of West Virginia introduced legislation to help make the buy-out of Weirton Steel possible — the largest employee-owned company in America and considered one of the most successful ESOPs.
- Sen. Bob Packwood, R-Ore., former chairman of the Senate Finance Committee, who called ESOPs the "bulwark of capitalism" during a debate on the 1986 Tax Reform Act.

Others, such as Sens. Paul Simon D-Ill., Jim Sasser D-Tenn., and Albert Gore Jr. D-Tenn., do not serve on the Senate Finance Committee but have still demonstrated their support to the idea of broadening employee ownership. On the House Ways and Means Committee, Reps. Beryl F. Anthony Jr., D-Ark., and Charles Rangel, D-N.Y., have been big ESOP supporters.

The ESOP constituency has grown to an estimated 8,000 plans covering 8 million workers in 1986 from about 1,600 plans covering 248,000 employees in 1975, according to statistics provided by the National Center for Employee Ownership, Oakland, Calif. The center also reported that in 1985, 550 firms adopted ESOPs and 800,000 employees became participants.

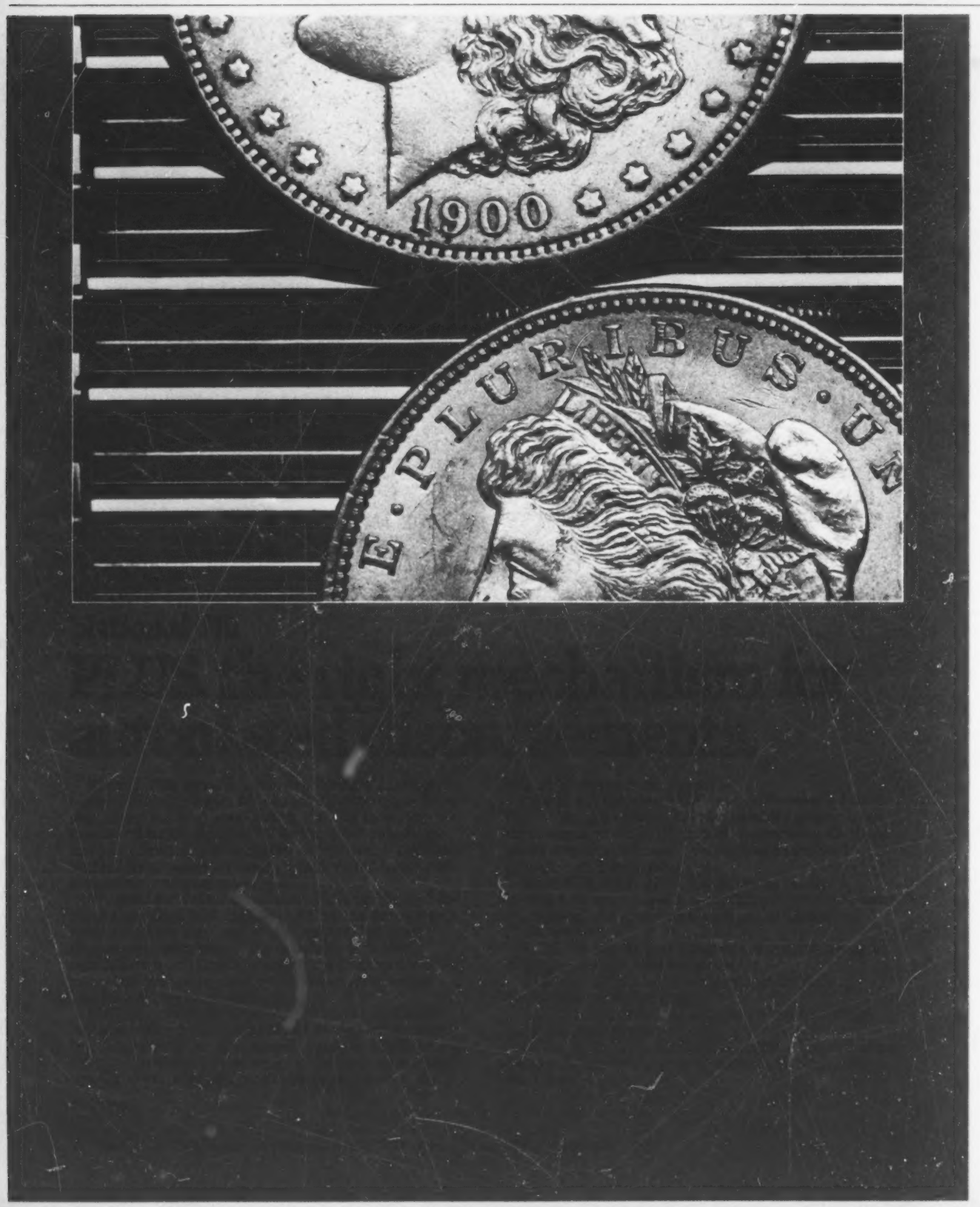
Mr. Zimmerman explained, "There was strong growth after the 1984 act (DEFRA), but the 1986 act really gave ESOPs a big boost, so you can expect that growth to continue and accelerate."

In other developments aiding the growth of ESOPs, Mr. Binns pointed to the increasing role of mid-size and regional banks in financing.

Sam Wessinger, communications director at the Employee Stock Ownership Association, explained: "Banks lost most of their opportunities for tax-free interest income with the 1986 Tax Reform Act. I don't know how aware banks are that ESOPs are all that is left when it comes to tax-free income."

Mr. Binns also said ESOPs, which were typically the mechanism by which privately held and small firms were passed along by their founders to employees, have drawn the interest of big business.

He cited the use of ESOPs by such companies as Ashland Oil Inc., Ashland, Ky.; Enron Corp. Inc., Houston; Unocal Corp., Los Angeles; Lowe's Cos. Inc., North Wilkesboro, N.C.; E-Systems Inc., Dallas; and MCI Communications Corp., Washington. ■



Plans are . . .

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ment eventually wrote a "no action letter" in the proposed Scott & Fetzer deal, the department's concerns still inhibit ESOP leveraged buy-outs.

The Labor Department is set to issue guidelines on equity allocation within six months.

At issue in the controversy over the role of ESOPs in leveraged buy-outs is whether the retirement plan gets enough equity stake for the note that it invests in the transaction.

ESOPs bring tax benefits to a leveraged buy-out, but the value of these deductions hinges on whether the new company becomes a taxpayer.

Tax breaks are overrated as a force driving employee stock ownership, said Mr. Rosen.

"What we've concluded is that what is going to drive ESOP growth or not drive it is the perception among management that it is a way to improve corporate performance," Mr. Rosen said. "If that doesn't take hold, ESOPs will always be a minor footnote." ■

Cash Management

Divide to conquer

Splitting cash portfolios boosts returns

By Chuck Paustian

Some treasury executives are leading their corporate cash investment strategy out of the inertia of typical low-risk, short-term money market portfolios.

The idea, which doesn't depend on hiring outside money managers, is to divide corporate cash — typically handled as one lump portfolio — into different risk classes without jeopardizing operating capital.

Corporations can protect essential operating cash by keeping it in low-risk portfolios, while significantly boosting overall returns by investing the rest more aggressively.

John J. Murray, director-short-term investments and borrowing at Amoco Corp., Chicago, said company executives set aside a "very small percentage" of the overall portfolio of marketable securities for more aggressive investing.

"We have earned four times as much as we would have earned had we not set up this portfolio," he said.

Mr. Murray said recent returns weren't available, but noted the company's investment portfolio, which uses both longer-term and riskier instruments, has generated substantial returns. "By substantial I mean in some years, 40%, 30% and 20%," he said. Those returns were generated when money market instruments also were yielding much higher returns than they are today.

At the end of 1985, Amoco had a total of $834 million in marketable securities, including the aggressive portfolio.

A smaller company, Carl Karcher Enterprises, Anaheim, Calif., also segments its investible corporate cash, using four money managers to invest in preferred stocks.

"We've given guidelines as to how much, on a percentage basis, we can put into preferreds as opposed to (certificates of deposit) or overnight money," said Rick Roth, manager-cash planning at Carl Karcher. The company has about $50 million in cash and marketable securities.

Utilities, many of which have accumulated vast pools of cash, have started taking more aggressive approaches to their investments.

El Paso Electric Co., El Paso, Texas, is investing about $500 million in takeover arbitrage, leveraged dividend capture programs and other aggressive investments (*see related story at right*).

The Iowa-Illinois Gas and Electric Co., Davenport, Iowa, plans to set up an investment management subsidiary to run about $50 million in longer-term instruments, including leases. Iowa-Illinois has applied to the Illinois Commerce Commission for permission to start the subsidiary.

While money market rates hover around 5% and 6%, pretax returns in the upper teens can be obtained from less traditional investments such as preferred or common stocks.

Some financial service firms are preparing to provide the services to managers of corporate cash.

A research project conducted by Treasury Strategies Inc., Chicago, for Merrill Lynch Capital Markets, New York, found the 3,000 largest industrial companies had between $300 billion and $400 billion in short-term cash at the end of 1985, the latest available data.

"That's all investible, but some of it should only be overnight," said Anthony J. Carfang, a principal at Treasury Strategies. "We believe, of the $400 billion, about 10% should be turning over on a daily basis.

"Another $80 billion to $120 billion should fall into the short-term category, which is up to about six months. As much as $250 billion could go out longer than that," Mr. Carfang said.

Robert H. Arnold, director of corporate market strategy and development at Merrill Lynch, said although some companies segment cash positions to invest in riskier assets and more are hiring outside investment managers, the typical short-term approach is still the rule.

Because corporate cash represents the future of a company, cash managers generally prefer investments that offer little or no risk.

Typical corporate cash investments would include commercial paper, certificates of deposit, bankers acceptances and Treasury bills. While these instruments are fine for operating capital, cash managers tend to overuse them.

Mr. Arnold said he talked with executives of one company who had been investing several hundred million dollars in overnight repurchase agreements. But he believes cash managers are becoming more aware of the disadvantages of such programs.

"I think it's an appreciation that to get the kind of returns they're looking for, they have to broaden their perspectives in terms of the kinds of vehicles they're using and not treating their assets as a common pool," Mr. Arnold said.

He said treasury executives need to establish a link between their cash and overall corporate strategy to determine what portion of assets can be allocated to strategies aimed at boosting overall performance.

One way to maximize performance is to match the time horizons of the investment strategy to when the company will need that cash.

Investments with longer time horizons could offer similar quality and liquidity characteristics as more traditional cash investments, but carry higher returns because of the added interest rate risk.

Marvin Pember, senior vice president-finance at Oklahoma Healthcare Corp., Oklahoma City, said, because some of the corporate cash wasn't needed immediately to operate the hospital management company, that money was allocated to a long-term balanced strategy to be managed by Schaenen Wood & Associates Inc., New York.

"There's a restriction that (the assets) be 50% equity and 50% fixed income," said Mr. Pember, who declined to release the amount of assets given to Schaenen Wood.

"One of the major things we do when we get involved with a company is find out what their time horizon is," said Robert B. Maehr, director of mar-

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Payden & Rygel index of short maturity assets*
(for month ended Feb. 28)

	February 1987	Quarter ended 12/31/86	Year to date	12 months ended 2/28/87	Yield level monthly change*
	Unannualized total returns				
90-day					
U.S. Treasury bill	0.4744	1.2960	0.9908	6.4485	−15
Domestic CD	0.4234	1.4062	1.0281	6.8640	21
Euro $ CD	0.4307	1.4733	0.9833	6.9542	25
180-day					
U.S. Treasury bill	0.5099	1.3173	1.0400	7.0048	−13
Domestic CD	0.3519	1.3516	0.9541	7.1073	24
Euro $ CD	0.3624	1.4227	0.8816	7.1743	25
1-year					
U.S. Treasury note	0.4813	1.3461	1.0067	7.8497	−3
2-year					
U.S. Treasury note	0.4500	1.6459	1.0275	9.4143	2

*Figures are unannualized total returns. Year-to-date and 12-month figures linked monthly. 90- and 180-day Treasury bill yield level changes on discount basis.
*Basis points.

Source: Payden & Rygel, Los Angeles

State laws are forcing Maxicare, which operates HMOs such as this one, to segregate some cash management operations.

Banking costs rise for HMOs

By Barry B. Burr

Corporations operating health maintenance organizations are burdened with higher banking costs and lower investment returns because of state laws requiring HMOs to segregate some cash management operations.

State regulations generally call for the companies to provide collection and disbursement services or depositories for investment securities or some combination within the few states with the rules.

As a result, HMOs are having to decentralize cash management activities for certain states, so banking costs are higher than if they were consolidated among a few banks. Cash managers also complain that segregating cash management activities by state inhibits investment of idle cash, hurting returns.

"There is a movement toward total segregation of receipts, disbursements and investments" by each state in which HMOs operate, said Thomas Nannini, cash manager, Humana Inc., Louisville.

He said the rules are forcing the company "to segregate the whole cash flow process, from receipts to disbursements and investments — where the money's coming from, where it's going and how much cash you have."

A recently adopted rule in Georgia, for example, requires HMOs operating there to use an in-state bank for disbursements of claims paid to residents and collections of premiums paid by residents as well as holding securities of investments made with cash generated from the operations within the states.

As a result, Mr. Nannini said, Humana is using Citizens & Southern National Bank, Atlanta, for disbursements and collections for its Humana Health Plan Inc. unit.

In addition, Humana has to have separate lockboxes, as required by state regulation, in Florida and Nevada. In Florida, it also uses Citizens & Southern, which processes collections there. In Nevada, it uses First Interstate Bank, Las Vegas.

The states are the only ones of the 22 in which Humana operates HMOs with such regulations, Mr. Nannini said.

With its non-regulated HMOs, he said Humana uses Wachovia Bank & Trust Co., Winston-Salem, N.C., a unit of First Wachovia Corp., for disbursements, and a number of other banks for lockboxes.

Maxicare Health Plans Inc., a Los Angeles-based holding company that operates HMOs in about a dozen states, faces similar rules.

Jack Christensen, treasurer, said Maxicare recently opened separate disbursement accounts for its HMOs in Georgia

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